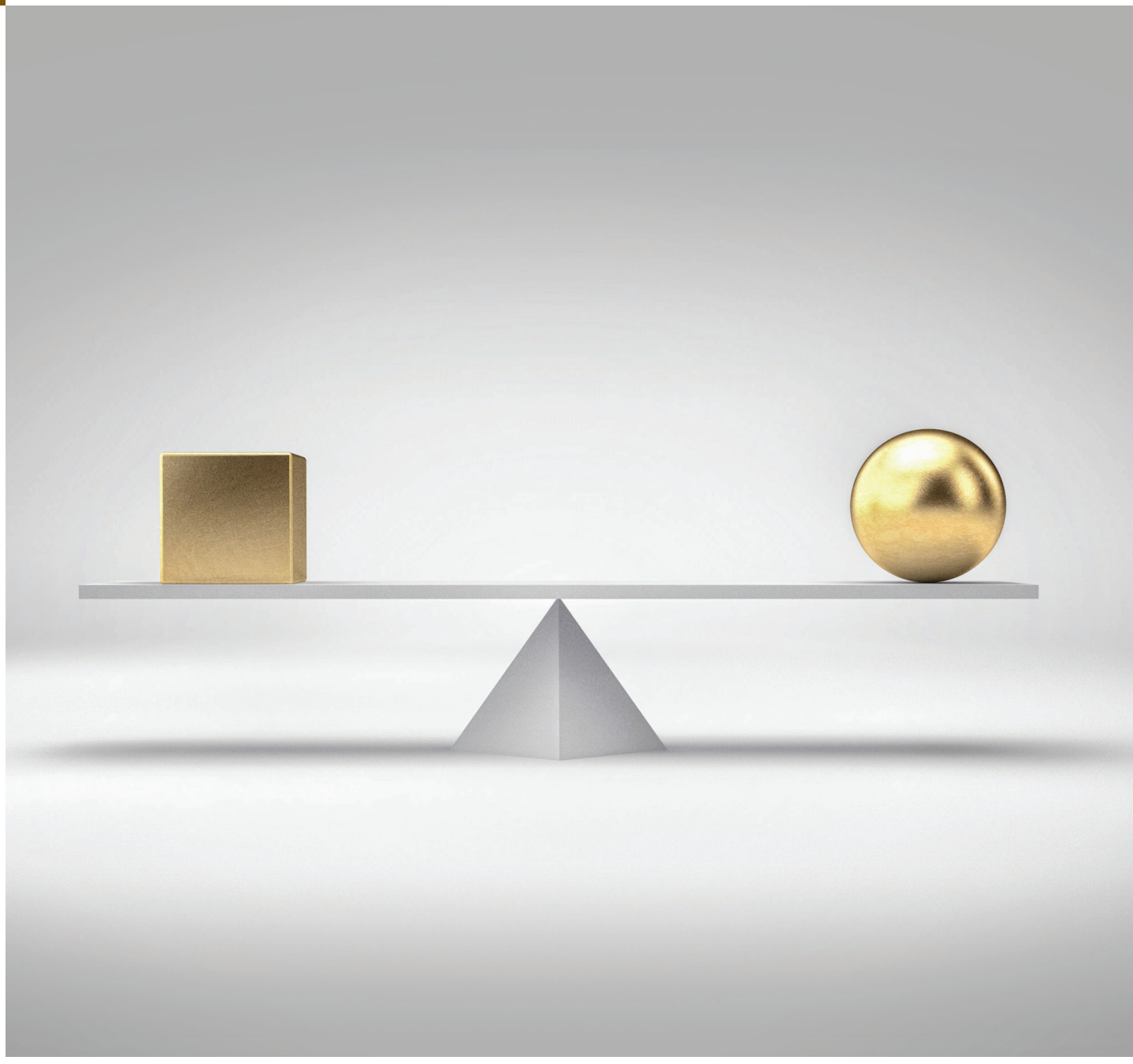

Sec. 403(b) retirement plans: A comparison with 401(k) plans

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Tax-exempt charities may adopt two types of funded tax-favored retirement plans. They may adopt Sec. 403(b) plans and they may adopt qualified plans (including Sec. 401(k) plans). Public schools may also adopt both 403(b) plans and qualified plans (not including 401(k) plans).[1] Many tax-exempt entities and public schools have chosen 403(b) plans, for what they perceive to be favorable features. This article highlights differences between 403(b) and 401(k) plans.

As background, Sec. 403(b) plans may be established by (1) tax-exempt educational, charitable, scientific, literary, sports, religious, or public safety testing organizations (hereafter "501(c)(3) organizations"); (2) public school systems (including Indian schools); (3) employers of religious ministers or self-employed ministers (an umbrella term covering other clergy members, too);[2] and (4) certain health and hospital service organizations.[3]

Sec. 403(b) plans are of three general types. The first type consists of commercially purchased annuities.[4] The second type is a custodial account that may invest only in regulated mutual funds (referred to hereafter in this article as a "custodial account").[5] The third type is a "retirement income account," a type of individual account plan only churches (a term that covers a wide variety of religious organizations) and their related organizations may establish. Retirement income accounts need not limit their investments to purchased annuities or mutual funds and may be established for self-employed ministers.[6]

An employee eligible to make both the special catch-up contribution and the over-50 catch-up contribution may elect both without offsetting one against the other.

The statutory tax law requirements for qualification as a 403(b) plan are generally not as strict at those applicable to qualified plans. Unfortunately, though, many of the stricter requirements are instead imposed on 403(b) plans by the labor law provisions of the Employee Retirement Income Security Act of 1974 (ERISA). ERISA grants protections to retirement plan participants, their spouses, and beneficiaries. Although a 403(b) plan that omits ERISA mandates is not disqualified for tax purposes, the omission will invite the imposition of civil and criminal penalties on the employer for labor law violations.[7] For that reason, employers normally provide for the more strict ERISA requirements in 403(b) plans.

Nevertheless, the ERISA requirements are not imposed on certain 403(b) plans referred to in this article as "unrestricted 403(b) plans." Unrestricted 403(b) plans include church plans, public school plans, and employee-sponsored 403(b) plans.[8] An employee-sponsored plan is a plan established by employees with minimal participation by the employer. In an employee-sponsored plan, the following requirements must be met:

1. Employee participation in the plan is voluntary.
2. The only involvement of the employer is to:
   a. Allow sellers of annuity contracts or custodial accounts to present their products to employees;
   b. Request information regarding the products and their sellers;
   c. Summarize information for employees;

1. State and local governments and their agencies and instrumentalities generally may not adopt 401(k) plans (Sec. 401(k)(4)(B)(ii)). Indian schools may, however, adopt 401(k) plans even though they are part of a tribal government (Sec. 401(k)(4)(B)(iii)). Rural cooperatives may also adopt 401(k) plans even if they are an instrumentality of state or local government (Sec. 401(k)(4)(B)(ii)). Furthermore, 401(k) plans of state or local government are grandfathered if they contained a cash or deferred provision before May 7, 1986 (Regs. Sec. 1.401(k)-1(e)(4)(iv)).
2. Sec. 403(b)(1)(A).
3. See IRS, *Employee Plan News* 2015-5 (May 6, 2015), available at tinyurl.com/yxlh7hfb.
4. Sec. 403(b)(1). A 403(b) plan must purchase its annuities from insurance companies, except for annuities purchased by certain grandfathered plans of state government units and except for certain life annuities paid by retirement income accounts (Regs. Sec. 1.403(b)-9(a)(5) and Regs. Secs. 1.403(b)-8(c)(1) and (c)(3)). The annuities must be nontransferable (Regs. Sec. 1.403(b)-3(a)(5)). Although an insurance contract generally cannot qualify as an annuity under a Sec. 403(b) plan, some death benefits under an annuity contract are allowable if they satisfy the incidental-benefit rule (Regs. Sec. 1.403(b)-8(c)(2)). Contracts issued before Sept. 24, 2007, are grandfathered from the rule in the preceding sentence (Regs. Sec. 1.403(b)-11(f)).
5. Sec. 403(b)(7); Regs. Sec. 1.403(b)-8(d).
6. Sec. 403(b)(9); Regs. Sec. 1.403(b)-9; preamble to T.D. 9142, §E. A retirement income account may pay a life annuity without purchasing a commercial annuity contract if the plan sponsor guarantees the annuity payments (Regs. Sec. 1.403(b)-9(a)(5)).
7. The Employee Retirement Income Security Act of 1974, P.L. 93-406, as codified in the Labor Code, imposes these stricter requirements on employers that sponsor Sec. 403(b) plans. See, e.g., 29 U.S.C. §1055 (qualified joint and survivor annuities and qualified preretirement survivor annuities) and 29 U.S.C. §1056(d) (assignment, alienation, and qualified domestic relations orders).
8. 29 U.S.C. §§1002(32), 1002(33), 1003(b)(1), and 1003(b)(2); 29 C.F.R. §2510.3-2(f).

   d. Collect, record, and submit amounts under salary reduction agreements;
   e. Hold employee group annuity contracts in the employer's name; and
   f. Limit products and sellers to those providing employees with a reasonable choice.
3. All rights in the annuity contract or custodial account are enforceable only by employees, beneficiaries, and their representatives.
4. The employer is entitled to compensation or reimbursement only for reasonable expenses incurred in administering a salary reduction agreement.[9]

Sec. 403(b) plans provide for salary reduction agreements under which an employee may elect to have a portion of his or her compensation contributed tax-free to the plan by the employer.[10] Sec. 401(k) plans similarly provide for cash or deferred arrangements allowing a participant to elect tax-free employer contributions to the plan.[11] Since practitioners are generally much more familiar with 401(k) plans than with 403(b) plans, this article discusses how 403(b) plans differ from 401(k) plans.

Note that this article does not purport to explain the differences between 403(b) plans and 401(k) plans to the extent those differences relate to formation and administration. Nor does it attempt to compare the rules governing the required coverage of employees (nondiscrimination) or the qualification of employees for coverage. Instead this article takes an actual participant's perspective by focusing on a comparison of the nature and amounts of contributions to, and distributions from, 403(b) and 401(k) plans, for an admittedly qualified participant.

In many ways, the provisions governing distributions from 403(b) and 401(k) plans are substantially the same. For example, the provisions are almost identical with respect to the treatment of plan loans, rollovers to and from the plans, applicability of the penalty on early distributions, required minimum distributions, and the availability of Roth conversions. Nevertheless, the differences can be significant. Those differences are discussed in the remainder of this article.

Types of contributions

One point of comparison between these two types of retirement plans concerns

9. 29 C.F.R. §2510.3-2(f).
10. Sec. 403(b)(1)(E).
11. Sec. 401(k)(2)(A).

EXECUTIVE SUMMARY

- Tax-exempt 501(c)(3) entities, public school systems, employers of ministers and self-employed ministers, and certain health and hospital service organizations may adopt 403(b) retirement plans. While 401(k) plans generally are subject to the Employee Retirement Income Security Act of 1974 (ERISA), many 403(b) plans (including church, public school, and employee-sponsored plans) are not.
- Employees can make elective contributions to 401(k) plans and to 403(b) plans. Employers can make nonelective and matching contributions to 401(k) plans and, if provided for in the plan documents, to 403(b) plans.
- The same basic limitation amount for elective contributions applies to both 401(k) and 403(b) plans, as does the over-50 catch-up contribution amount. However, employees with over 15 years of service may be able to make an additional special elective catch-up contribution to a 403(b) plan that cannot be made to a 401(k) plan.
- Employee elective contributions to 401(k) plans vest immediately; employer contributions must generally be totally vested under one of two vesting schedules. All contributions, employee and employer, must vest immediately in a 403(b) plan.
- When the commencement of distributions from 401(k) plans and from 403(b) plans can begin also differs. The commencement of distributions attributable to qualifying elective contributions (QECs), qualified nonelective contributions (QNECs), and qualified matching contributions (QMACs) from 401(k) plans are governed by the same rules. The rules governing commencement of distributions attributable to QECs from 403(b) plans are largely the same as these rules.
- With respect to hardship distributions, 403(b) plans have stricter rules than 401(k) plans regarding what funds can be used.
- An individual whose employer maintains both a 403(b) plan and a 457 government plan may be able to make contributions to the plans that are twice the contributions available if he or she participated in only the 403(b) plan (e.g., twice $19,500, or $39,000, for 2020 and 2021).

the contributions made to the plan. As noted above, both 403(b) plans and 401(k) plans provide that an employee may elect to have his or her employer contribute a portion of the employee's compensation to the plan in lieu of cash compensation. Such contributions are generally excluded from gross income and are referred to in this article as qualifying elective contributions (QECs). Roth contributions may also be QECs, except that they are taxable.[12]

An employer may also contribute to a 401(k) plan amounts designated as qualified nonelective contributions (QNECs) and qualified matching contributions (QMACs). QMACs are employer contributions that match an employee's elective contributions (QECs); these matching contributions must satisfy the same nonforfeitability and distribution commencement constraints that apply to QECs (as described below). QNECs are employer contributions other than QECs or QMACs that also satisfy the nonforfeitability and distribution commencement constraints applicable to QECs.[13]

Unlike 401(k) plans, 403(b) plans do not expressly provide for QNECs or QMACs (although the IRS has indicated that 403(b) plans may voluntarily provide for them).[14] This difference becomes important when comparing contributions to, and distributions from, the two types of plans.

Annual limits on contributions

There is a difference between 403(b) and 401(k) plans related to annual contribution limits. Generally, QECs for a tax year are limited by statute to the lesser of an employee's compensation or an inflation-adjusted dollar amount ($19,500 for 2020 and 2021).[15] This basic limit applies to the aggregate of all QECs made on behalf of an employee to 401(k) and 403(b) plans.[16]

If an employee over age 50 has already made the maximum allowed QECs (equal to the basic limit) to 401(k) and 403(b) plans, the plans may nevertheless allow the employee to make additional QECs that are catch-up contributions.[17] Catch-up contributions to the plans for a tax year are limited in the aggregate to the lesser of (1) an inflation-adjusted dollar amount ($6,500 for 2020 and 2021), or (2) the amount of the employee's compensation reduced by QECs already made under the basic limit.[18]

In addition, if an employee has completed 15 years of service, 403(b) plans of certain educational, medical, welfare, and church organizations may allow an employee to make additional QECs that are special catch-up contributions. This special catch-up provision is specifically designed to compensate for allowable QECs not taken in prior years. It is limited to $3,000 in any one tax year and is limited to $15,000 for all tax years.[19] An employee eligible to make both the special catch-up contribution and the over-50 catch-up contribution may elect both without offsetting one against the other.[20]

The substantial requirements and restrictions imposed by ERISA apply to most 401(k) and 403(b) plans. They do not apply, however, to unrestricted 403(b) plans.

In addition, for each employee, the aggregate of contributions and forfeitures to 401(k), 403(b), and other defined contribution plans (not including 457 government plans) generally may not exceed an overall inflation-adjusted dollar amount ($57,000 for 2020 and $58,000 for 2021).[21] Rollover funds

12. Regs. Secs. 1.401(k)-1(f)(1) and 1.403(b)-3(c).
13. Sec. 401(k)(3)(D)(ii). See also the definitions of QNECs and QMACs at Regs. Sec. 1.401(k)-6. Note that QMACs can be vested even though they could be subsequently forfeited because they are based on the matching of excess elective contributions or deferrals (Regs. Sec. 1.401(k)-2(b)(4)(iii)).
14. Preambles to T.D. 9875 and REG-107813-18. See also IRS, "Retirement Plan FAQs Regarding 403(b) Tax Sheltered Annuity Plans," available at tinyurl.com/ybxm8xda.
15. Secs. 402(g)(1) and (4); Notice 2019-59; Notice 2020-79. The basic limit on QECs does not apply to rollover contributions (Sec. 402(g)(3); Regs. Secs. 1.403-4(a) and (b)(1)).
16. Secs. 402(g)(1), (3), and (4); Regs. Sec. 1.402(g)-1(a). The Code states that a basic limit also applies to IRAs that are SEPs or simple retirement accounts (Sec. 402(g)(3)). SEPs may, however, contain only grandfathered cash or deferral features existing before 1997 and, in addition, an employer maintaining a 403(b) plan is necessarily a tax-exempt entity or state government unit that is not allowed to maintain even a grandfathered cash or deferred feature in a SEP (Secs. 408(k)(6)(E) and (H)). Further, an employer may not adopt a simple retirement account with a cash or deferred feature if the employer maintains an active 403(b) or 401(k) plan (Sec. 408(p)(2)(D)).
17. Note that the plan can impose its own basic limit on QECs if the plan limit is less than the statutory limit. In that event, the over-50 catch-up contributions would consist of contribution amounts that exceed the lesser plan limit (Regs. Sec. 1.414(v)-1(b)(2)).
18. Secs. 402(g)(1)(C) and 414(v); Regs. Secs. 1.402(g)-2 and 1.414(v)-1(c)(1); Notice 2019-59; Notice 2020-79. If the plan basic limit applies, the catch-up contributions cannot exceed the employee's compensation reduced by QECs already contributed in the amount of the plan limit (Regs. Sec. 1.414(v)-1(b)(2)).
19. Sec. 402(g)(7); Regs. Sec. 1.403(b)-4(c)(3).
20. Regs. Secs. 1.403(b)-4(c)(3)(iv) and (c)(5), Example (4).
21. Secs. 415(a) and (c); Notice 2019-59; Notice 2020-79. The overall contribution limitation applicable to defined contribution plans is not changed or otherwise affected by the fact that the employer also maintains one or more defined benefit plans (Small Business Job Protection Act of 1996, P.L. 104-188, §§1452(a) and (d)(1)).

and over-50 catch-up contributions are, however, not subject to this limitation.[22]

Finally, 401(k) and 403(b) plans are subject to various complicated nondiscrimination provisions that might have the effect of further limiting contributions by or for highly compensated employees.[23] Of note is one such provision that limits the amount of an employee's compensation that may be taken into account in computing contributions to the plan (compensation of $285,000 for 2020 and $290,000 for 2021).[24]

An employee participating in both a 403(b) plan and a 401(k) plan

In some cases, an employer may have more than one type of retirement plan. An employer with a 403(b) plan may also adopt a 401(k) plan, but generally only if the employer is a tax-exempt entity that is not a public school system and is not a 501(c)(3) organization with substantial governmental attributes.[25] Nevertheless, a public school system or governmental-type 501(c)(3) organization may also maintain a 401(k) plan if the plan was adopted before May 7, 1986.[26] Depending on the circumstances, there may be advantages to maintaining both a 401(k) plan and a 403(b) plan. As explained above, though, because of the single QEC basic limit and single over-50 catch-up limit applicable to 401(k) and 403(b) plans, maintaining a 401(k) plan in addition to a 403(b) plan will not increase the QECs or catch-up contributions that an employee may make.

An employee participating in both a 403(b) plan and a 457 government plan

It is worth mentioning Sec. 457 government plans here, too. An employee of a public school system or a 501(c)(3) organization with substantial governmental attributes may derive substantial benefit if his or her employer maintains both a 403(b) plan and a 457 government plan.[27] Although not the focus of this article, a 457 government plan is a type of cash or deferred plan established by a state or local government or its agencies or instrumentalities.[28]

An employee who participates in both a 457 government plan and a 403(b) plan may be able to make QECs to the plans that are double the QECs available if he or she participated in only one of the plans. For example, for both 2020 and 2021, the employee could potentially make QECs totaling $19,500 to the 457 government plan and QECs totaling $19,500 to the 403(b) plan, for a total QEC deferral of $39,000.[29] Observe though that, because the limitation on contributions also applies to non-QEC contributions to a 457 government plan, such contributions may crowd out potential QEC contributions to the 457 plan.[30]

The employee may also double up a permitted over-50 catch-up contribution since the catch-up limitation ($6,500 for both 2020 and 2021) is applied separately to the 403(b) plan and to the 457 government plan.[31] In addition, an employee of a qualifying educational, medical, or welfare organization who is participating in both types of plans may still potentially take advantage of the special 403(b) catch-up contribution for employees with 15 years of service (limited to $3,000 per year as discussed above).[32]

Furthermore, if the 457 government plan permits, an employee or the employer may also be able to make the special catch-up contributions that are generally available to employees in the last three years ending before they reach normal retirement age. The amount of the special catch-up is generally equal to the contributions the employee could have made, but did not make, for prior years. Nevertheless, total contributions made by or for the employee for a tax year, including both regular contributions and the additional contribution amount, may not exceed twice the normal dollar limit on contributions to the 457 government plan for the tax year (e.g., twice $19,500, or $39,000, for both 2020 and 2021).[33]

If an employee participating in a 457 government plan is eligible for both the over-50 catch-up and the special catch-up, the employee may take only the one yielding the larger overall contribution for the tax year.[34]

22. Secs. 415(a), (c), and (k)(1); Notice 2019-59.
23. Secs. 403(b)(12), 401(k)(3), and 401(m); Regs. Secs. 1.401(k)-2 and 1.403(b)-5.
24. Sec. 401(a)(17); Regs. Sec. 1.401(a)(17)-1; Notice 2020-79.
25. Sec. 401(k)(4)(B)(ii). For extensive discussion of 501(c)(3) organizations with substantial governmental attributes, see Notice 2015-7; Announcement 2011-78; proposed regulations, REG-155608-02.
26. Regs. Sec. 1.401(k)-1(e)(4)(i). In addition, though, Indian tribal government units and rural cooperatives that are state government units may adopt 401(k) plans (Secs. 401(k)(4)(B)(ii) and (iii)).
27. A state government unit with a 457 government plan may also maintain a 403(b) plan only if the governmental unit is a public school system, or if it is a 501(c)(3) organization that is also treated as a state government unit because of its close relationship with state or local government (Sec. 403(b)(1)(A)(ii); Notice 2015-7; Announcement 2011-78; proposed regulations, REG-155608-02).
28. Sec. 457.
29. IRS Letter Ruling 200934012.
30. Sec. 457(b)(2); Regs. Secs. 1.457-4(c) and 1.457-2(b). Although the aggregate of contributions and forfeitures to 401(k), 403(b), and other defined contribution plans generally may not exceed an overall inflation-adjusted dollar amount ($57,000 for 2020 and $58,000 for 2021), this limitation does not apply to contributions and forfeitures to 457 government plans (Secs. 415(a) and (c); Notice 2019-59; Notice 2020-79).
31. Sec. 414(v)(2)(D).
32. Sec. 402(g)(7); Regs. Sec. 1.403(b)-4(c)(3); IRS Letter Ruling 200934012.
33. Sec. 457(b)(3); Regs. Sec. 1.457-4(c)(3).
34. Secs. 414(v)(6)(C) and 457(e)(18); Regs. Secs. 1.457-4(c)(2)(ii) and (iii), Examples (2) and (3).

Vesting schedules and forfeitures

Vesting rules are another area where 401(k) and 403(b) plans differ. It is axiomatic that a plan's benefit may be distributed only to the extent it has vested and become nonforfeitable. For 401(k) plans, the benefit attributable to *employee* contributions, and attributable to *employer* contributions of elective deferrals (QECs), is always vested in most 401(k) plans and can never become forfeitable.[35] Nor can amounts attributable to other *employer* contributions become forfeitable merely because a participant withdraws amounts attributable to *employee* contributions, if the participant already had a nonforfeitable right to at least 50% of the plan's accrued benefit.[36]

Equally important, the benefit attributable to *employer* contributions to 401(k) plans must generally (1) be totally vested after three years of service or (2) be 20% vested after two years of service, reaching 100% vesting after six years of service.[37] The rate of accrual of the benefit may not be slowed because of age.[38]

On the other hand, for 403(b) plans, these kinds of vesting requirements are generally irrelevant because *all* employer and employee contributions to 403(b) plans must be immediately vested and nonforfeitable.[39] It is also worth noting that immediate vesting of contributions is required for 401(k) plans that meet the stringent requirements for a "simple" 401(k) plan.[40] Unfortunately, though, an employee actively participating in a 403(b) plan may not participate in a simple 401(k) plan.[41] If an employer nevertheless attempts to purchase a forfeitable annuity contract from an insurance company for a 403(b) plan, the employer will instead be treated as purchasing a nonqualified annuity contract under Sec. 403(c).[42] If certain exacting conditions are then met, the employer may thereafter treat the forfeitable annuity contract as a part of the 403(b) plan as the annuity contract vests.[43]

Earliest date distributions may begin

Another point of comparison between plans relates to when distributions may begin. Looking first at 401(k) plans, although the terms of the plan generally determine when the plan may commence distributions, the tax law puts significant limits on how soon distributions may begin from plan funds attributable to QECs, QNECs, and QMACs.[44] That is, a 401(k) plan generally may not commence distributions from these funds before the earliest of:

1. The participant's severance from employment;[45]
2. The calendar year the participant reaches age 59½;[46]
3. The disability of the participant;[47]
4. The death of the participant;[48]
5. A hardship of the participant;[49]
6. A qualified birth or adoption;[50]
7. Service in the uniformed services for more than 30 days;[51]
8. Active duty by a military reservist;[52] or
9. Termination of the plan.[53]

35. Secs. 401(k)(2)(C) and 411(a)(1); 29 U.S.C. §1053(a).
36. Sec. 401(a)(19); 29 U.S.C. §1056(c).
37. Sec. 411(a)(2)(B); 29 U.S.C. §1053(a)(2)(B).
38. Sec. 411(b)(2); 29 U.S.C. §1054(b)(1)(H)(i).
39. Sec. 403(b)(1)(C); Regs. Sec. 1.403(b)-3(a)(2).
40. Secs. 401(k)(11)(A)(iii) and 408(p)(3). Simple 401(k) plans are most usually adopted to avoid the more onerous nondiscrimination provisions of regular 401(k) plans. See generally Secs. 401(k)(11) and 408(p).
41. Sec. 401(k)(11)(C); Regs. Sec. 1.401(k)-4(c).
42. Regs. Sec. 1.403(b)-(3)(d)(2)(i). Note that if an employer attempts to make a forfeitable contribution to a custodial account, the resulting disqualified account will continue to be exempt from federal income tax (Regs. Sec. 1.403(b)-(8)(d)(4)).
43. Regs. Sec. 1.403(b)-(3)(d)(2)(ii).
44. Sec. 401(k)(2)(B)(i). In addition, employer contributions and matching contributions can qualify as QNECs and QMACs, respectively, only if the plan specifies that funds attributable to the contributions may be distributed no earlier than funds attributable to QECs. See the definitions of QNECs and QMACs at Regs. Sec. 1.401(k)-6.
45. Sec. 401(k)(2)(B)(i)(I).
46. Secs. 401(k)(2)(B)(i)(III) and (k)(7)(C). Commencement at age 59½ does not apply to pre-ERISA money purchase plans (Sec. 401(k)(6)).
47. Sec. 401(k)(2)(B)(i)(I).
48. Id.
49. Secs. 401(k)(2)(B)(i)(IV) and (k)(7)(C). Commencement upon hardship does not apply to pre-ERISA money purchase plans (Sec. 401(k)(6)).
50. Sec. 72(t)(2)(H).
51. Secs. 414(u)(12)(B)(i) and 401(k)(2)(B)(i)(I); Notice 2010-15. Uniformed services include the armed forces, the Army National Guard, the Air National Guard, and other miscellaneous services (id., Sec. 3401(h)(2)(A); 38 U.S.C. §4303(16)).
52. Sec. 401(k)(2)(B)(i)(V). A severance from employment that will allow commencement of distributions occurs under a 401(k) plan when an employee who is a military reservist reports to active duty. The plan may make a distribution of elective deferrals to the employee if the period of active duty is at least 179 days or an indefinite period. The employee will not incur the penalty for early distribution. Within a two-year period after completion of active duty, the reservist may make voluntary nondeductible contributions to an IRA or Roth IRA in an aggregate amount not exceeding the active-duty distributions. If a distribution satisfies both the reservist rule and the 30-day uniformed services rule, the reservist rule controls to the extent there is any conflict (Notice 2010-15).
53. Sec. 401(k)(2)(B)(i)(II). Upon termination of a Sec. 403(b) plan containing interests in Sec. 403(b)(7) custodial accounts, the plan may generally distribute individual custodial accounts (ICAs) tax-free if certain conditions are met. In that case, the ICAs may continue to be treated as if they were Sec. 403(b) plans, and funds in the ICAs are not taxed until distributed. Rev. Rul. 2020-23 sets forth the rules for the distribution of ICAs by plans that are not required to provide spousal annuities under Section 205 of ERISA (29 U.S.C. §1055). The IRS is, however, having difficulty reconciling spousal annuity requirements with the distribution of ICAs and has asked for comments from practitioners regarding the problem (Notice 2020-80).

Plan-to-plan transfers from a 403(b) plan to a qualified governmental plan that is a defined benefit plan are not taxable to a participant or beneficiary if certain conditions are met.

In addition, if and when a "lifetime income investment" may no longer be held as an investment option under the plan, the plan may distribute or transfer the investment to the participant or to another retirement plan.[54]

If the funds distributed are not attributable to QECs, QNECs, or QMACs (i.e., funds attributable to other employer and employee contributions), the tax law puts few constraints on the commencement of 401(k) distributions. The 401(k) plan need only provide for commencement of distributions "after a fixed number of years, the attainment of a stated age, or upon the prior occurrence of some event such as layoff, illness, disability, retirement, death, or severance of employment."[55]

For 403(b) plans, on the other hand, the rules on when distributions may begin differ in certain respects from 401(k) plans, as discussed in the subsections below.

Categories of 403(b) funds subject to constraints on commencement of distributions

For funds attributable to QECs, the 403(b) rules on commencement of distributions are largely the same as the 401(k) rules described above for the commencement of distribution of QEC funds. Those rules apply to 403(b) distributions of QEC funds whether the distributing plan consists of purchased annuities, a custodial account, or a retirement income account.[56] One important difference from 401(k) plans, though, is that Sec. 403(b) and the regulations thereunder do not expressly provide for QNECs or QMACs, although the IRS concedes that a 403(b) plan has the option to provide for them.[57]

For funds in a custodial account that are not QEC funds, the commencement of distribution rules are the same as for QECs,[58] except that a hardship will not trigger a distribution.[59] For 403(b) plans that are *not* custodial accounts, the tax law allows considerable latitude in providing for commencement of distributions of those funds not attributable to QECs, QNECs, and QMACs (i.e., funds attributable to other employer and employee contributions). For these residual funds, a 403(b) plan has the same freedom to prescribe the timing of commencement that, as described above, a 401(k) plan has with respect to funds not attributable to QECs, QNECs, and QMACs.[60]

Although the specific events that allow 403(b) plans and 401(k) plans to commence distributions are largely the same for funds attributable to QECs, there are some notable differences relating to hardships, military reservists, and pre-1989 elective deferrals.

Commencement of distributions upon hardship

A hardship that may allow a distribution is defined in the same way for 403(b) plans and 401(k) plans. For both types of plans, a hardship is an immediate and heavy financial need.[61] The differences lie in the categories of plan funds that may be used to make a hardship distribution. For 401(k) plans, hardship distributions may be drawn from plan funds attributable to QECs, QNECs, and QMACs.[62] For 403(b) plans the rule is largely the same, except that hardship distributions may *not* be drawn from earnings on QECs nor from funds in custodial accounts that are not QEC funds.[63] Otherwise, it does not matter whether the funds are in an annuity contract or a retirement income account.[64]

Severance due to reservist's call to active duty

A severance from employment allowing commencement of distributions occurs under either a 403(b) plan or a 401(k) plan when a participant who is a

54. Secs. 401(a)(38), 403(b)(7)(A)(i)(VI), and 403(b)(11)(D). Such transferable lifetime income investments include optional annuities payable in substantially equal annual (or more frequent periodic) intervals over the life of the participant or the joint lives of the participant and his or her designated beneficiary. Such investments also include an optional investment with a feature guaranteeing a minimum level of income annually (or more frequently) for at least the life of the participant or the joint lives of the participant and his or her designated beneficiary (Sec. 401(a)(38)(B)(iii)).
55. Regs. Secs. 1.401-1(b)(1)(ii) and (iii). Although this regulation applies directly only to profit-sharing and stock bonus plans, most 401(k) plans *are* profit-sharing and stock bonus plans. A few are pre-ERISA money purchase plans or rural cooperative plans (Sec. 401(k)(2)).
56. Sec. 403(b)(11); Regs. Sec. 1.403(b)-6(d).
57. Preambles to T.D. 9875 and REG-107813-18.
58. Sec. 403(b)(7)(A)(i).
59. Sec. 403(b)(7)(A)(i)(V).
60. Regs. Secs. 1.403(b)-6(b), 1.401-1(b)(1)(ii), and 1.401-1(b)(1)(iii). Although the latter regulation applies, by its terms, only to profit-sharing and stock bonus plans, the former regulation stretches it to apply to 403(b) plans.
61. Sec. 403(b)(11); Regs. Sec. 1.403(b)-6(d)(2).
62. Sec. 401(k)(14)(A); Regs. Sec. 1.401(k)-1(d)(1)(ii)(B). See also the definitions of QNECs and QMACs at Regs. Sec. 1.401(k)-6.
63. Preambles to T.D. 9875 and REG-107813-18.
64. Sec. 403(b)(11) (last sentence); Regs. Sec. 1.403(b)-6(d)(2).

military reservist reports to active duty. The plan may make a distribution to the reservist if the period of active duty is at least 179 days or an indefinite period.[65] For 401(k) plans, reservist distributions may be drawn from funds attributable to QECs, QNECs, and QMACs[66] (although distributions from funds attributable to QNECs or QMACs may be subject to the early-distribution penalty if no exception applies).[67]

For 403(b) plans, a literal interpretation of the statutory language indicates reservist distributions may be drawn only from funds attributable to QECs (i.e., both QECs and earnings thereon).[68] It is possible, however, that the IRS may also allow reservist distributions from funds attributable to QNECs and QMACs by analogy to its generous allowance of hardship distributions from such funds.

Grandfather treatment of pre-1989 assets

A special rule applies to 403(b) assets held as of the close of the last year beginning before Jan. 1, 1989. For custodial accounts, the entire amount of such assets may be distributed upon hardship without regard to whether the assets were derived from QECs, QNECs, QMACS, or otherwise. For annuity contracts and retirement income accounts, the current restraints on commencement of distributions do not apply at all to distribution of the grandfathered assets.[69] There is no similar grandfather provision for 401(k) distributions.

ERISA requirements not imposed on unrestricted 403(b) plans

Another point of comparison concerns how ERISA affects the plans. As noted above, with some exceptions ERISA requirements are imposed on qualified plans, including 401(k) plans, by both the tax law and the labor law. ERISA is similarly imposed on most 403(b) plans under the labor law. Those labor law requirements are, however, not applicable to unrestricted 403(b) plans (i.e., church, public school, and employee-sponsored plans).[70] Perhaps the most significant of the inapplicable requirements are the three discussed immediately below.

Mandatory commencement of distributions

One requirement inapplicable to unrestricted 403(b) plans involves mandatory commencement of distributions. Sec. 401(k) plans are generally required to begin paying retiree benefits by a specific date. If the retiree does not elect to delay the payments (or the plan does not allow a delay),[71] the specified date is the 60th day after the *latest* of the plan years the retiree (1) reaches age 65, or reaches the plan's normal retirement age if earlier; (2) reaches the 10th anniversary of initial participation in the plan; or (3) terminates his or her service with the employer sponsoring the plan. If a retiree separated from service after meeting all the requirements for early retirement benefits except the age requirement, the plan must provide the retiree with a retirement benefit when he or she subsequently reaches the early retirement age.[72]

An unrestricted 403(b) plan, however, need not provide any similar mandatory date for the commencement of distributions.

Spousal annuity requirements

A second requirement inapplicable to unrestricted 403(b) plans involves spousal annuities. Sec. 401(k) plans are generally required to pay a participant's retirement benefit in the form of annuities that are designed to protect spouses and surviving spouses.[73] A plan subject to spousal annuity requirements must generally make provision for two different types of annuities: (1) a qualified joint and survivor annuity for the participant and his or her spouse, and (2) a qualified preretirement survivor annuity for the surviving spouse of a participant who dies before retirement.[74] Unrestricted 403(b) plans, however, are not required to provide these annuities.

Assignment or alienation

A third requirement inapplicable to unrestricted 403(b) plans involves assignment or alienation. The benefits under a 401(k) plan or most 403(b) plans generally may not be assigned or alienated, although there are exceptions for certain small voluntary and revocable assignments, for qualified domestic relations orders (QDROs), and for certain judgments and settlements related to the plan.[75] An unrestricted 403(b) plan, however, need not prohibit assignments or alienations.

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65. Secs. 72(t)(2)(G), 401(k)(2)(B)(i)(V), 403(b)(7), and 403(b)(11); Regs. Sec. 1.401(k)-1(d)(1)(iv); Notice 2010-15.
66. Sec. 401(k)(2)(B)(i)(V); Regs. Sec. 1.401(k)-1(d)(1)(iv). See also the definitions of QNECs and QMACs at Regs. Sec. 1.401(k)-6.
67. Secs. 72(t)(2)(G), 402(g)(3)(A), and 401(k)(2)(B)(i)(V).
68. Secs. 72(t)(2)(G), 402(g)(3)(C), 403(b)(7), and 403(b)(11).
69. Sections 1123(c) and (e)(2) of the Tax Reform Act of 1986, P.L. 99-514; and Section 1011A(c)(11) of the Technical and Miscellaneous Revenue Act of 1988, P.L. 100-647.
70. 29 U.S.C. §§1002(32), 1002(33), 1003(b)(1), and 1003(b)(2); 29 C.F.R. §2510.3-2(f).
71. Regs. Sec. 1.401(a)-14(b).
72. Sec. 401(a)(14); 29 U.S.C. §1056(a).
73. Secs. 401(a)(11) and 417; 29 U.S.C. §§1055(a) and (b). See also Blankenship, "Required Spousal Annuities Under Qualified Retirement Plans," 117 *Tax Notes* 783 (Nov. 19, 2007).
74. Secs. 417(b) and (c); 29 U.S.C. §§1055(d) and (e). A participant may waive these annuities, but only with the consent of his or her spouse. Sec. 417(a); 29 U.S.C. §§1055(c)(1) and (2).
75. Sec. 401(a)(13)(A); 29 U.S.C. §1056(d)(1).

Inclusion as optional provisions

The ability to include optional provisions is worth mentioning here. Although 403(b) plans need not address certain matters, such as those mentioned above, an employer nevertheless may draft a 403(b) plan that includes such provisions. The IRS has clearly indicated that the plan may include such optional provisions as hardship withdrawals, plan-to-plan transfers, and receipt of rollovers. Optional provisions need only "meet, in both form and operation, the relevant requirements under section 403(b)" and the regulations thereunder.[76] An example of an optional provision failing this test would be a provision allowing commencement of distributions after 10 years of service: Such a provision would violate the statutory language limiting commencement to other specific types of events.

Qualified domestic relations orders

Plans also differ in their handling of QDROs. The tax law uses this term to refer to a domestic relations order of a court that directs a plan to pay benefits to a participant's spouse, former spouse, children, or other dependents (alternate payees). The tax law generally imposes strict requirements on QDROs. Thus, QDROs under most 403(b) or 401(k) plans generally may not require any benefit or option not otherwise available under the plan.[77] Nor may such a QDRO require payment of benefits with a value greater than the value of benefits otherwise provided under the plan.[78]

QDROs issued with respect to 403(b) plans of churches or governmental units are, however, not subject to the same strict rules applicable to most QDROs. Instead, they are subject to the more lenient rules applicable to QDROs under qualified governmental plans and qualified church plans.[79] They need only provide for the payment of plan benefits to an alternate payee, without being subject to any additional requirements or prohibitions.

Applicability of state community property laws

Another comparison to make between plans involves state community property laws. If a participant resides in a community property state while working, the participant's spouse may acquire a 50% ownership interest in amounts the participant earns. These state community property laws do not apply to participants in most 403(b) or 401(k) plans because community property laws are generally preempted by ERISA.[80] They do, however, apply to participants in unrestricted 403(b) plans (because such plans are exempted from ERISA).[81] Thus, if a participant was covered by an unrestricted 403(b) plan while residing in a community property state, his or her spouse may have acquired a community property interest in plan benefits as they accrued.[82]

Nevertheless, community property laws do not apply to the determination of compensation for purposes of applying the limits on the amount of QECs that can be made to an unrestricted 403(b) plan.[83] Note also that special rules may apply to community income of spouses who live apart, and in certain other unusual circumstances.[84] Community property states are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin.

Plan payment for participant's life insurance

The proceeds from a life insurance contract owned by a 401(k) or 403(b) plan may be payable to a participant's beneficiary, either directly or indirectly. If so, the participant may have to include some or all of the cost of the insurance in his or her gross income. More specifically, the participant must include the portion of the insurance cost paid from funds contributed by the employer or paid from funds earned by the plan.[85] Fortunately, inclusion in a participant's gross income of life insurance costs paid by a 401(k) plan will not trigger the additional tax on early distributions. It is also unlikely the IRS would attempt to apply the additional tax to insurance costs paid by a 403(b) plan since the IRS determines the includible life insurance costs for 403(b) plans by analogy to qualified plans.[86]

Transfers to buy service credits or repay contributions

Plan-to-plan transfers from a 403(b) plan to a qualified governmental plan that is a defined benefit plan are not taxable to a participant or beneficiary if certain conditions are met. Participants or beneficiaries may request such transfers to purchase permissive service credit for otherwise nonqualifying or nonexistent periods of service under the recipient defined benefit plan.[87] Alternatively, participants or beneficiaries may use the transfers to reinstate service credits in the recipient defined benefit plan that were forfeited because of previous

76. Regs. Sec. 1.403(b)-3(b)(3)(i).
77. Sec. 414(p)(3)(A).
78. Sec. 414(p)(3)(B).
79. Secs. 414(p)(11) and (p)(1)(A)(i).
80. *Boggs v. Boggs*, 520 U.S. 833 (1997).
81. 29 U.S.C. §§1002(32), 1002(33), 1003(b)(1), and 1003(b)(2); 29 C.F.R. §2510.3-2(f).
82. IRS Letter Rulings 201021048 and 201021050.
83. Sec. 402(g)(5); Regs. Sec. 1.402(g)-1(f).
84. Sec. 66.
85. Secs. 72(m)(3)(B) and 404(a)(8)(C); Regs. Secs. 1.72-16(b)(2), 1.403(b)-8(c)(2), and 1.403(b)-6(g). The life insurance must be an incidental benefit (Rev. Rul. 79-202; Regs. Sec. 1.403(b)-6(g)).
86. Notice 89-25, Q&A 11; Regs. Sec. 1.403(b)-6(g).
87. Sec. 415(n)(3).

distributions.[88] These transfers are not distributions; thus, the plan may make the transfers before age 59½ and before retirement.[89]

Lump-sum distributions for participants born before 1936

If a participant in a 401(k) plan was born before Jan. 2, 1936, the participant (or more likely his or her beneficiary) may be entitled to special tax treatment for a lump-sum distribution from the plan. The recipient may be able to choose to (1) pay tax on a portion of the distribution at a 20% tax rate, or (2) compute the tax on some or all of the distribution by averaging the income and applying a special tax rate schedule.[90] This special grandfather provision is not available to participants in 403(b) plans.[91]

The big picture

From a participant's standpoint, the immediate nonforfeitability of *all* contributions to a 403(b) plan is a plus for 403(b) plans (even considering the possibility of a delayed-vesting workaround for insurance company annuity contracts). On the other hand, the nonforfeitability of plan funds attributable to QECs, QNECS, and QMACs adds much of the same protection for 401(k) plans, even though that protection does not extend to other 401(k) plan funds.

Unfortunately, the tax law imposes stricter limits on the amount of hardship and military reservist distributions for participants in 403(b) plans than for those in 401(k) plans. A 401(k) plan may allow hardship and reservist distributions from funds attributable to QECs, QNECs, and QMACs. For 403(b) plans the rule is largely the same, except that they may not provide hardship distributions from earnings on QECs or from funds in a custodial account other than QEC funds. Similarly, it appears that 403(b) plans may allow distributions to reservists called to active duty only from funds attributable to QECs, although there is a slim possibility the IRS would also allow distributions attributable to optional QNECs or QMACs.

The substantial requirements and restrictions imposed by ERISA apply to most 401(k) and 403(b) plans. They do not apply, however, to unrestricted 403(b) plans (i.e., church, public school, and employee-sponsored plans). As a result, the terms of an unrestricted 403(b) plan need not provide for ERISA-mandated provisions, such as for spousal annuities, anti-alienation clauses, or mandatory distributions. Or, alternatively, the terms of the 403(b) plan may simply include its own version of such provisions.

An employee of a public school system or a 501(c)(3) organization with significant governmental attributes may derive substantial benefit if his or her employer maintains both a 403(b) plan and a 457 government plan. An employee who participates in both a 403(b) plan and a 457 government plan may be able to make contributions to the plans that are twice the contributions available if he or she participated in only the 403(b) plan (e.g., twice $19,500, or $39,000, for 2020 and 2021). An employee over 50 could also potentially double up the over-50 catch-up contributions since the catch-up limitation ($6,500 for 2020 and 2021) is applied separately to 403(b) plans and 457 government plans. ■

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88. Sec. 415(k)(3).
89. Sec. 403(b)(13); Regs. Sec. 1.403(b)-10(b)(4); IRS Letter Ruling 200550042.
90. Tax Reform Act of 1986, P.L. 99-514, §1122(h)(3); Sec. 402(e)(4)(H) (1986); Notice 2018-74. Form 4972, *Tax on Lump-Sum Distributions*, states that a participant is qualified if he or she was born before Jan. 2, 1936.
91. *Rheal*, T.C. Memo. 1989-525; *Adamcewicz*, T.C. Memo. 1994-361.